

**Franchise Tax Board****ANALYSIS OF ORIGINAL BILL**

Author: Calderon Analyst: Jahna Alvarado Bill Number: ABX3 27  
Related Bills: See Legislative History Telephone: 845-4372 Introduced Date: September 5, 2008  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Research & Development Credit-Deny For Taxable Years Beginning On Or After January 1, 2008, And Before January 1, 2011, Allow Transfer Of Credits To Affiliated Corporations For Taxable Years Beginning On Or After January 1, 2011, And Before January 1, 2014

**SUMMARY**

This bill would temporarily deny the Research (R&D) Credit and allow a taxpayer to transfer the credit, as specified.

**PURPOSE OF THE BILL**

The bill language indicates the purpose is to address the fiscal emergency proclaimed by the Governor on January 10, 2008.

**EFFECTIVE/OPERATIVE DATE**

As a tax levy, this bill would be effective immediately upon enactment and operative for taxable years beginning on or after January 1, 2008.

**POSITION**

Pending.

**ANALYSIS****FEDERAL/STATE LAW**

Existing federal law allows taxpayers an R&D credit in the amount of 20% of the excess qualified research expenses. The research credit is designed to encourage companies to increase research and development activities.

**Board Position:**

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ <u>X</u> PENDING

Department Director

Date

Brian Putler

03/16/09

For Selvi Stanislaus

To qualify for the credit, research expenses must qualify as an expense or be subject to amortization, be incurred in the U.S., and be paid by the taxpayer. The research must be experimental or laboratory research and pass a three-part test as follows:

1. Research must be undertaken to discover information that is technological in nature. The research must rely on the principles of physical, biological, engineering, or computer sciences.
2. Substantially all of the research activities must involve experimentation relating to quality or to a new or improved function or performance.
3. The application of the research must be intended for developing a new or improved business component. This is a product, process, technique, formula, or invention to be sold, leased, or licensed, or used by the taxpayer in a trade or business.

Ineligible expenses include seasonal design factors; efficiency surveys; management studies; market research; routine data control; routine quality control testing or inspection; expenses incurred after production; or development of any plant, process, machinery, or technique for the commercial production of a business component unless the process is technologically new or improved.

The federal credit does not apply to any expenses paid or incurred after December 31, 2009.<sup>1</sup>

California conforms to the federal credit with the following modifications:

- ♦ The state credit is not combined with other business credits.
- ♦ Research must be conducted in California.
- ♦ The credit percentage for qualified research expenses in California is 15% versus the 20% federal credit.
- ♦ The credit percentage for basic research payments in California, limited to corporations, is 24% versus the 20% federal credit.
- ♦ The California alternative incremental research expense credit (AIRC) rates are 1.49%, 1.98%, and 2.48% versus the federal rates of 3%, 4%, and 5%, respectively.
- ♦ The alternative simplified credit is not available.

Only the entity that incurs research and development expenses may claim the California R&D credit; the credit cannot be shared among the members of a unitary group.<sup>2</sup>

The California R&D credit is allowed for taxable years beginning on or after January 1, 1987, and is permanent without regard to whether the federal credit is operative.

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<sup>1</sup> Emergency Economic Stabilization Act of 2008 (Public Law 110-343).

<sup>2</sup> *General Motors Corp v. FTB*, (2006) 39 Cal4th 773

## THIS BILL

This bill would do the following:

1. Deny the R&D credit for expenditures during taxable years beginning on or after January 1, 2008, and before January 1, 2011.
2. Allow a taxpayer to transfer the R&D credit, including carryovers, to any affiliated corporation for use in the same manner as the credit would have been used by the taxpayer for taxable years beginning on or after January 1, 2011, and before January 1, 2014.
3. Define the term affiliated corporation as a corporation that is a member of a commonly controlled group as defined in Revenue and Taxation Code Section 25105.

## IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

1. This bill would allow the Corporation Tax Law (CTL) credit to be assigned to any affiliated corporation. An affiliated corporation is not necessarily in a similar line of business, or a member of a unitary group if the tests of unity are not satisfied during the year. If it is the author's intent that the assignment of credits be limited to affiliated corporations benefiting from the R&D activity, the author may wish to amend this bill to narrow the definition of "affiliated corporation".
2. This bill would allow the CTL credit to be assigned to any affiliated corporation. It is unclear what limitations, if any, would be applicable regarding this assignment and how assignments would be reported to the department. This could lead to disputes between the taxpayer and the department. It is suggested the bill be amended to clarify this provision.

## TECHNICAL CONSIDERATIONS

A taxpayer subject to tax under the Personal Income Tax Law (PITL) would not have an "affiliated corporation", as defined by this bill. Therefore, the section of this bill that adds Revenue and Taxation Code Section 17052.12(j), is ineffective. Amendment 1 would eliminate this ineffective language.

For consistency, for this bill's provisions that would amend the CTL, the author may desire to substitute language similar to Revenue and Taxation Code Section 23610.5(q), which provides for the "election" to assign the credit for low-income housing to affiliated corporations, instead of this bill's current language that provides for the "transfer" of the R&D credit to affiliated corporations.

## LEGISLATIVE HISTORY

AB 1452 (Committee on Budget, Stats. 2008, Chap. 763) limits the allowable tax credits for a corporate taxpayer with income subject to tax equal to or greater than \$500,000 to 50% of the tax before application of any credits. The limitation applies to taxable years beginning on or after January 1, 2008, and before January 1, 2010. AB 1452 also allows a corporate taxpayer to make a one time, irrevocable assignment of certain credits to an affiliated corporation as defined for taxable years beginning on or after July 1, 2008. Assigned credits can not reduce tax for taxable years beginning before January 1, 2010.

AB 751 (Lieu, 2007/2008) would have increased the research credit for increasing qualified research expenses from 15% to 20% for taxable years beginning on or after January 1, 2007, and would have also fully conformed to the federal AIRC for taxable years beginning on or after January 1, 2007. AB 751 failed to pass out of the Assembly Revenue & Taxation Committee.

SB 359 (Runner, 2007/2008) would have, among other things, increased the Qualified Research Expense Credit from 15% to 16% and conformed to the federal AIRC. SB 359 failed to pass out of the Senate Revenue and Taxation Committee.

AB 2032 (Lieu, 2005/2006) would have increased the amount of the Qualified Research Expense Credit from 15% to 18%. AB 2032 failed to pass out of the Assembly Revenue & Taxation Committee.

AB 2567 (Arambula, 2005/2006) would have conformed the amount of the Qualified Research Expense Credit to the amount allowed at the federal level. AB 2567 failed to pass out of the Assembly Revenue and Taxation Committee.

AB 483 (Harman, 2001/2002) and SB 1165 (Brulte, 2001/2002) would have increased the credit for qualified research expenses from 15% to 20%. AB 483 was held in the Senate Revenue and Taxation Committee. SB 1165 failed to pass out of the originating house by the constitutional deadline.

AB 511 (Stats. 2000, Ch. 107) increased the state credit for qualified research expense from 12% to 15%.

## OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

*Florida* allows corporate taxpayers to claim a corporate income tax credit for tax years beginning on or after January 1, 2007, for certain "eligible costs" for renewable energy technologies investment. The credit incurred by an affiliated corporation may be used to reduce the tax imposed upon the consolidated group. Additionally, the credit may be transferred to a surviving or acquiring entity after a merger or acquisition. *Florida* lacks a comparable credit for personal income taxpayers because *Florida* has no state personal income tax.

*Illinois* corporate and individual taxpayers may claim an income tax credit for qualified expenditures that are used for increasing research activities in *Illinois*. The credit equals 6 ½% of the qualifying expenditures. When determining eligibility for the research and development credit, an increase in research activities is calculated based on the research activities conducted by all members of the combined group in *Illinois*, not individual members' research activities.

*Massachusetts* allows corporate taxpayers to claim an income tax credit for qualified expenditures that are used for increasing research activities in *Massachusetts*. The credit is 15% of the basic research payments and 10% of qualified research expenses conducted in *Massachusetts*. If a corporation files a combined return of income, a credit generated by an individual member corporation must first be applied against the excise attributable to that corporation. A member corporation with excess credit may apply the excess credit against the excise of another member if such other member may use additional credits.

*Minnesota* allows corporate taxpayers a credit equal to 5% for qualified research expenses up to \$2 million. The amount of the credit is reduced to 2.5% for expenses exceeding the first \$2 million. The credit may not be allocated or transferred to a member of a unitary business.

*Michigan* allows corporate taxpayers a credit for a percentage of the compensation for services paid by the taxpayer that is engaged in research and development of a hybrid system for propelling motor vehicles. An eligible taxpayer may claim a credit against the Single Business Tax equal to 6.5% of the excess of qualified research expenses paid in the tax year that relate to pharmaceutical-based business activity in *Michigan* paid during the three immediately preceding tax years.

Beginning in 2005, *New York* allows a credit for qualified emerging technology companies. The credit is equal to 18% of the cost of research and development property, 9% of the qualified research expenses, or the costs of high-technology training expenditures paid by the taxpayer. The credit is limited to \$250,000 per taxable year.

## **FISCAL IMPACT**

If the bill is amended to resolve the implementation considerations addressed in this analysis, the department's costs would be expected to be minor.

## **ECONOMIC IMPACT**

### Revenue Estimate

It is estimated that the revenue impact from this bill would be as shown in the following table:

Estimated Revenue Impact of ABX3 27 Effective for tax years BOA 1/1/2008 Enacted after 6/1/2008 \$ in Millions			
2008-09	2009-10	2010-11	2011-12
+\$1,440	+\$1,310	+\$770	-\$495

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

### Revenue Discussion

The revenue impact of each of the two provisions of this bill would be dependent upon the following factors.

#### **Temporary denial of research and development credits**

The revenue gain from this suspension is estimated in two steps. First, the amount of research and development credit claimed by corporate taxpayers for the latest tax year is estimated based on actual corporate tax returns for the 2007 tax year. This amount is adjusted downward to account for the expected increase in deductions of research expenses as a result of this suspension. In the second step, this revenue gain is increased by 6% to account for PIT taxpayers. This percentage represents the proportion of R&D credits claimed by PIT taxpayers. For the 2007 tax year revenue gain from this suspension is estimated to be \$1,305 million. This 2007 gain is extrapolated to future tax years based on the Department of Finance's (DOF) May 2008 forecast of corporate profits.

#### **Transfer of credits among affiliated corporations**

The revenue loss from allowing the transfer of research and development credits among affiliated corporations is based on the assumption that a unitary relationship exists between the transferor and transferee corporations and is simulated using the 2005 sample of corporate tax returns. Only corporations that filed combined returns, had unused research and development credits, and paid more than minimum taxes are used in this simulation. For estimation purpose, the tax of a corporation filing a combined return is recomputed with the assumption that unused R&D credit is allowed to be used until either its tax is reduced to the minimum tax, or the unused R&D credit is exhausted. The difference between the recomputed tax and actual tax is the revenue loss. For the 2005 tax year revenue loss from this provision is estimated to be -\$200 million. The 2005 revenue loss is extrapolated to 2011 and later tax years based on DOF May 2008 forecast of corporate profits.

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO ABX3 27  
As Introduced

AMENDMENT 1

On page 4, ~~strikeout~~ lines 1-9, inclusive.